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INTERNATIONAL OUTLOOK 1987

Economists make predictions not because they know, but because they are asked.

John Kenneth Galbraith in *The New York Times*, November 23, 1986

Members of The Conference Board's Economic Forum, meeting in mid-November, were pretty much in agreement that the outlook for the U.S. economy in 1987 would be "more of the same"—namely, a continued, if none too spectacular, advance in overall economic activity and continuation of present levels of inflation and interest rates.

With the United States accounting for about one-quarter of global output, the 1987 prospects for the rest of the world are largely similar:

- Economic growth, in both the industrial and the developing countries, will be somewhat—but not much—better than in 1986.
- Inflation is expected to remain subdued in the industrial countries, largely as a result of lower oil and commodity prices, and to recede somewhat in the developing countries.
- The volume of world trade is likely to register a slight decline, while recent exchange-rate shifts are expected to reduce the major industrial countries' external imbalances somewhat.

Modest Growth in 1987

The outlook for the major industrial countries for 1987 is for only modest growth over 1986—and for several of them lower growth rates than in 1985 (Table 1). The latest economic forecasts for 1987, both by official organizations and by corporate economists, incorporate downward revisions from projections made earlier in 1986. These adjustments reflect the rather disappointing results of the first half of 1986 in the industrial countries and weaker prospects for the export earnings of the developing countries. Indeed, by last summer earlier arguments for a fairly strong world economic performance in 1987 no longer appeared convincing. Ironically, it is the admittedly slim improvement in the 1987 outlook for the oil-producing countries, because of the recent firming of oil prices, that provides the bulk of what improvement is foreseen for the world economy as a whole (Chart 1).

Chart 1

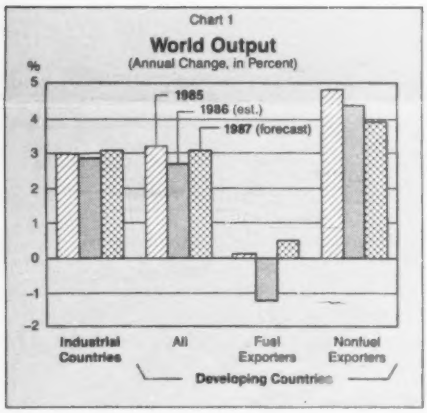

Table 1

Gross National Product, Major Industrial Countries
(Annual changes, in percent)

	1985 Actual	*1986 Estimated*	*1987 Projected Range*
Canada	4.0	3.3	2.8 - 3.6
France	1.3	2.2	2.0 - 3.0
Germany	2.5	3.0	2.5 - 3.8
Italy	2.3	2.8	2.5 - 3.8
Japan	4.5	2.6	1.5 - 3.5
United Kingdom	3.3	2.4	2.0 - 3.0
United States	2.7	2.7	1.4 - 3.5

Sources: 1985 and 1986: International Monetary Fund. 1987: International Monetary Fund, Commission of the European Communities, Barclays Bank, Banque Paribas, Swiss Bank Corporation, Merrill Lynch, U.S. corporate estimates.

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During the second half of 1986 two elements of potential weakness were emerging. First, in the major industrial countries outside the United States exports were beginning to make a smaller contribution to overall output than they had in the mid-1980s. Second, while last year's sharp decline in oil prices had generally been hailed as potential stimulus to global economic activity, it soon became clear that the negative effects of the price drop on the oil and oil-related industries in the industrial countries initially were outweighing any positive effects on consumer incomes.

The question now is not whether the effects of lower oil prices on consumer spending—reinforced outside the United States by the drop in the dollar—have merely been delayed, but whether they will provide a major boost at all. In fact, energy prices paid by consumers in the major industrial countries have by no means fallen by as much as had been anticipated, partly because of higher energy taxes. As against a decline of some 55 percent in spot oil prices by last summer, local prices paid by domestic consumers in major countries had generally fallen by much less (Table 2).

Table 2

Decline in Oil Product Prices
July 1985-July 1986
(Percent changes, in national currencies)

	Gasoline	*Heating Oil*
Italy	- 4.8%	-18.6%
Japan	-11.7	-12.8
France	-16.1	-44.0
United Kingdom	-18.2	-39.6
Germany	-26.2	-58.9
United States	-29.0	-35.1

It also is worth noting that over the past year the industrial countries have benefited from sizable gains in their terms of trade as prices of manufactured goods have risen relative to the price of oil and nonoil commodities. But there is little evidence that these countries have attempted to stimulate their own economies sufficiently to offset the corresponding deterioration in the purchasing power of the developing countries. According to calculations by Barclays Bank, demand growth in 1987 in the seven major industrial countries (the so-called Group of Seven) will exceed the growth of actual output in the seven by just over 0.4 percent, compared with 1.0 percent in 1986. Thus, the stimulus provided to the developing world by industrial country demand will be substantially less than last year.

The European Community

Despite the common experience of lower oil prices and the depreciation of the dollar, the member countries of the European Community (EC) will follow differing growth patterns in 1987. The two major energy producers—the Netherlands and the United Kingdom—are expected to experience a slight slowdown of their economies. Certain other countries with large public-sector deficits and sizable external deficits have adopted various restraint measures, whose impact may more than offset the effects of lower oil prices and of the lower dollar. This is especially true for Greece and, to a lesser extent, for Belgium and Denmark.

In addition—and in some cases as part of budgetary corrections—a number of countries have recently raised energy taxes or the official prices charged for various energy products. These countries include Spain, Portugal, Greece, Italy, Ireland and Denmark.

Looking to 1987, the projected growth rates for the members of the EC range between -0.2 percent (Greece) and 3.6 percent (Portugal). As regards individual countries, the European Commission predicts that Germany, Ireland, Italy and Portugal will experience growth rates above the projected EC average of 2.8 percent; France and Spain will grow at about the EC average; the British economy will be slightly below the average; and the Benelux countries and Denmark will not be able to grow by much above 2 percent.

The Commission is at pains to point out that, while the 1987 outlook may represent an improvement over recent years, it still remains below the rates "necessary for a significant and durable reduction in unemployment."

Japan

On the basis of current projections, there is little reason to expect much of a pickup in economic activity in Japan in 1987. This is true even in the face of the discount rate cut and the comprehensive tax reform package

announced at the end of October. The rate cut is mostly symbolic and unlikely to have much of a stimulating effect, largely because the discount rate is not indicative of domestic borrowing costs. The effects of the proposed tax reform would make themselves felt only some years from now—and then only if the various parts of the package succeeded in boosting domestic investment and consumption.

With the ye[illegible]pected to remain firm and the effects of its appreciation to date still to be translated completely into altered trade patterns, those sectors of the Japanese economy exposed to foreign competition will continue to weaken.

Inflation To Remain Moderate

Inflation prospects for 1987 look fairly promising. In the industrial countries, increases in the consumer price index are expected to remain quite moderate. For those countries as a group, the CPI is projected to rise by 3.0 percent, as compared to 2.2 percent last year. In Germany and Japan, the price level is expected to remain virtually unchanged (Table 3). This relatively good inflation picture, the best in two decades, owes much to declining oil and commodity prices and to the effects of appreciating exchange rates for the major currencies. As these effects begin to weaken, inflation may well pick up again somewhat. However, the underlying inflation rate, as measured by the GNP deflator, is actually expected to be somewhat lower in 1987 than last year.

Chart 2

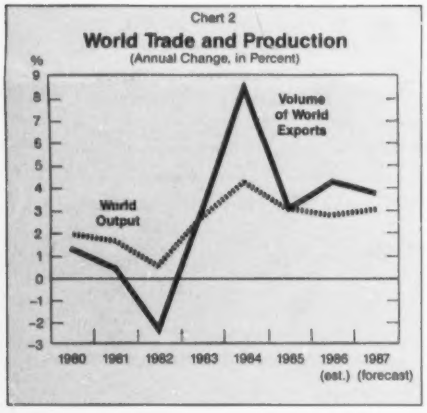

Table 3

Consumer Price Index, Major Industrial Countries
(Annual changes, in percent)

	1985 Actual	*1986 Estimated*	*1987 Projected Range*
Canada	4.0	4.2	3.5 - 4.5
France	5.8	2.7	2.2 - 3.0
Germany	2.2	-0.2	0.5 - 1.5
Italy	9.2	6.0	4.8 - 6.0
Japan	2.1	0.5	-0.2 - 1.2
United Kingdom	5.7	4.2	3.0 - 4.0

Sources: 1985 and 1986: International Monetary Fund. 1987: International Monetary Fund, Commission of the European Communities, Barclays Bank, Banque Paribas, Swiss Bank Corporation, Merrill Lynch, U.S. corporate estimates.

For the developing countries, inflation rates are seen as receding considerably, largely because of recent successes, in a number of previously high-inflation countries, in breaking the inflationary spiral. Thus, for four of those countries—Argentina, Bolivia, Brazil and Israel—the composite inflation rate is projected to drop from over 300 percent in 1985 to 119 percent in 1986.

This particular phenomenon is largely responsible for the projected decline in the average inflation rate for all developing countries, from about 40 percent in 1985 to 28 percent in 1986 and 16 percent this year. Even for the fifteen largest debtor countries, average inflation is expected to fall from 123 percent in 1985 to 77 and 32 percent in 1986 and 1987, respectively.

Smaller External Imbalances

The conclusion that the industrial countries "may not be doing enough" to boost global demand is reinforced by their balance-of-payments experience. The combined current-account surplus of the industrial countries outside the United States is expected to improve dramatically, from $64 billion in 1985 to $123 billion in 1986 (Table 4). A small deterioration, to a surplus of $110 billion, is projected for 1987, when the 1985-1986 exchange-rate shifts should begin to affect trade volume (Chart 2). But the improvement over the 1985-87 period suggests that demand in the major industrial countries will not have expanded sufficiently to offset the adverse effects of the decline in commodity prices on the rest of the world.

Table 4

Current-Account Balances
(Billions of dollars)

	1985 Actual	1986 Estimated	1987 Projected
Industrial countries	-53.5	0.0	-11.6
Industrial countries, excl. United States	64.2	123.0	111.4
Germany	13.3	30.8	25.5
Japan	49.2	82.7	74.1
Developing countries	-19.0	-57.6	-46.5
Fuel exporters	4.3	-38.9	-24.0
Nonfuel exporters	-23.3	-18.7	-22.5

Within the group of industrial countries, a significant feature of the outlook for both 1986 and 1987 is continuation of a current-account deficit of over $120 billion for the United States, as well as the persistence of sizable surpluses for both Germany and Japan. (The figures for Germany and Japan are somewhat misleading, however, since they are in dollar terms and hence are inflated by the recent depreciation of the dollar.) Expressed as a percentage of gross national product—which is considered a more satisfactory measure of external balance—IMF projections indicate that the U.S. payments deficit should decline from 2.9 percent of GNP in 1985 to 2.7 percent in 1987. Germany's surplus is projected to rise from 2.1 percent of GNP in 1985 to 3.4 percent in 1986 and then drop to the equivalent of 2.5 percent in 1987. For Japan, a projected rise from 3.7 percent of GNP in 1985 to 4.1 percent in 1986 is expected to be followed by a relatively sharp drop to 3.3 percent this year, as the effects of the yen appreciation are beginning to be fully felt.

These modest reductions in the payments imbalances of the three largest industrial countries, although welcome, seem to imply that that the exchange-rate shifts that have occurred since the first quarter of 1985 may not be sufficient by themselves to make the three countries' current-account positions more sustainable from here on.

Improved Policy Coordination?

With the external imbalances of the major countries expected to remain relatively large, the question naturally arises whether better coordination of national economic policies could play a role in moving toward a more sustainable external equilibrium. Most European policymakers would argue that, to judge by the 1987 outlook for their countries, there really is no growth problem for Europe and therefore no need for Europe to try and "grow harder."

The various U.S. suggestions that the Europeans stimulate their economies by monetary and/or fiscal measures, both to prop up the world economy and help reduce the U.S. payments deficit, reflect what Swiss Bank Corporation recently labeled "a sort of Pavlovian response"—that is, the belief that changes in one part of an economic system will result in definite and controllable changes in another. The Europeans are not quite as sanguine on that score.

While European policymakers agree that surplus countries have their part to play in reducing global payments imbalances, they do feel that, by their own standards, growth prospects are relatively encouraging and that the forces working in that direction do not need to be reinforced by policy measures. Moreover, they do not buy the argument that a more expansionary policy stance would lead to much additional growth in imports—and still less to measurable growth in imports of U.S. products.

U.S. attempts to influence other countries' policy directions fall under the much vaunted rubric of "international economic policy coordination." But as recent events have made amply clear, coordination—which would imply a significant modification of national policies in recognition of international economic interdependence—may very well be a dead letter. Bilateral cooperation, such as the recent U.S.-Japan accord involving a discount rate cut and a broadly based tax reform by Japan, may be more appropriate and at the same time more acceptable to deal with policy differences as they arise.

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